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CLIENT ALERT

Anti-Injunction Suit Doesn't Bar APA Challenge to Tax-Penalty Backed Reporting Requirement

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On May 17, the Supreme Court ruled that a pre-enforcement challenge to an IRS reporting requirement may proceed despite the IRS's assertion that the Anti-Injunction Act prohibited the lawsuit. Typically, the Tax Court is the sole venue for a pre-collection litigation on the merits of an IRS assessment. Absent a Tax Court petition, under the Anti-Injunction Act, taxpayers cannot sue in the district courts to stop the IRS from assessing and collecting taxes. Instead, the taxpayer must pay the tax (or the IRS tells the taxpayer it owes tax) and then file a lawsuit challenging the legality of the tax. The government has long used the Anti-Injunction Act as a tool to stop pre-enforcement challenges to any tax-related guidance. However, the Supreme Court made clear in *CIC Services, LLC v. IRS et al*. that this tool is limited.

Background

CIC Services challenged IRS Notice 2016-22, which listed certain micro-captive transactions—typically, insurance agreements between a parent company and "captive" insurer—as "reportable transactions." Accordingly, taxpayers and certain advisors involved with these micro-captive transactions were obligated to report these transactions to the IRS, via information returns that detail each such transaction. If the taxpayer or material advisor fails to comply with the information reporting requirements, they are subject to civil and criminal penalties. The civil penalties are considered a "tax." The criminal penalties may include a fine and up to a year in prison, and they are not a tax.

After the IRS issued Notice 2016-22, advisor CIC Services filed a lawsuit asking a district court to bar the IRS from requiring information returns on micro-captive transactions. CIC Services argued that Notice 2016-22 violated the Administrative Procedures Act because it was effectively a new regulatory requirement that the IRS issued without the benefit of notice and comment rulemaking and because it is arbitrary and capricious. The government argued the Anti-Injunction Act barred the lawsuit. The district court agreed and dismissed the case. The Sixth Circuit affirmed that decision, and the Supreme Court granted certiorari.

The Supreme Court's Ruling

In the unanimous decision penned by Justice Kagan, the Court held that in order to determine whether the Anti-Injunction Act applied, it needed to determine the purpose of CIC's lawsuit. If CIC filed the suit to challenge a reporting obligation, the suit was not barred by the Anti-Injunction Act. If CIS Services filed the suit to challenge the IRS's ability to assess the civil tax penalty for not complying with the reporting requirement, then the suit was barred by the Anti-Injunction Act.

Based on three aspects of the "reportable transaction" regulatory scheme, the Court concluded the lawsuit challenging Notice 2016-22 was a challenge to the reporting requirement, not to any eventual tax obligation. First, Notice 2016-22 does not actually levy any tax. Instead, it imposes a reporting obligation, and a separate statute imposes the civil tax penalty. Justice Kagan noted that this obligation alone imposes costly compliance requirements. Second, failure to comply with the reporting obligation does

not automatically trigger the tax penalty—the tax penalty is imposed only after the IRS investigates, confirms there was a violation, and makes the discretionary decision to impose the tax penalty. Therefore, the connection between the Notice and the potential tax obligation is a few steps removed. Third, failure to comply with the reporting requirements is also punishable by a non-tax criminal penalty. Accordingly, this is the type of suit ripe for injunctive relief—allowing plaintiffs to challenge without risking criminal fines or jail time.

What This Means for Taxpayers

The full reach of the opinion is unknown. Justice Sonia Sotomayor raised the question of whether the *CIC Services* holding applies to taxpayers. CIC Services had a reporting obligation because it was an advisor. Justice Sotomayor suggested that the Court's holding may be different if a taxpayer brought the suit; she stated that a tax on noncompliance with the reporting requirement may be a "rough substitute" for the tax liability it evades by withholding the required information.

Regardless, this is another in a long line of cases that eats away at "tax exceptionalism" by emphasizing that IRS sub-regulatory action is not immune from challenge under the Administrative Procedure Act, and providing taxpayers with a pathway to mount pre-enforcement challenges to at least some IRS sub-regulatory actions. All the same, the Supreme Court stressed that this decision "will not open the floodgates to pre-enforcement tax litigation" because the Anti-Injunction Act still bars pre-enforcement challenges to taxes.

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[1] IRC § 6011(a).

[2] IRC § 6707.

[3] IRC § 6671(a).

[4] IRC § 7203.

[5] *Direct Marketing Assn. v. Brohl,* 575 U.S. 1 (2015) (holding that Anti-Injunction Act does not apply to reporting requirements even they facilitate the collection of taxes).

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